**AGENCY FOR INTERNATIONAL DEVELOPMENT**
**PPC/CDIE/DI REPORT PROCESSING FORM**

**ENTER INFORMATION ONLY IF NOT INCLUDED ON COVER OR TITLE PAGE OF DOCUMENT**

**1. Project/Subproject Number**
497-0357

**2. Contract/Grant Number**
497-C-00-98-00045-00

**3. Publication Date**
3 April 2001

**4. Document Title/Translated Title**
Policies and Institutions to Ensure Free Internal Trade under Decentralization

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**6. Contributing Organization (s)**
Nathan/Checchi Joint Venture/PEG Project

**7. Pagination**
20

**8. Report Number**
PEG 39

**9. Sponsoring A.I.D. Office**
ECG, USAID/Jakarta

**10. Abstract (optional - 250 word limit)**

**11. Subject Keywords (optional)**
1. Indonesia
2. Decentralization
3. Domestic trade
4. Economic policies
5. Economic institutions
6. Free trade

**12. Supplementary Notes**

**13. Submitting Official**
C. Stuart Callison, Chief of Party

**14. Telephone Number**
011-62-21-520-1047

**15. Today's Date**
17 September 2001

…...………………………………………..……………DO NOT write below this line…………………………………….……………

**16. DOCID**

**17. Document Disposition**
DOCRD [ ] INV [ ] DUPLICATE [ ]

**AID 590-7 (10/88)**

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# Policies and Institutions to Ensure Free Internal Trade under Decentralization

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*Paper presented at the PEG/USAID one-day conference on 'Domestic Trade, Decentralization, and Globalization,' Borobudur Hotel, April 3rd, 2001*[1]

## *Introduction*

The domestic trade of goods and services, on which a country's prosperity depends, is a matter of national concern. Long historical experience shows that when a country permits local governments to freely tax and regulate trade, and forbid the free movement of citizens, the economy and polity suffer. The economy suffers because local governments impose unnecessary costs and burdens on trade, making all goods more expensive. Citizens buy less than they otherwise would. Production then often declines, rather than increases, because the trade barriers local governments put in place limit, rather than expand, the size of markets. While it may be that some few persons, especially local government officials, are better off, more people, and the country as a whole, are worse off.

Free trade, by contrast, makes everyone better off. The economy grows more rapidly and produces a greater surplus and more employment. With increasing prosperity, government revenues go up, both national and local government revenues. In familiar terms, as the pie becomes larger, everyone gets a larger share of pie. It is in everyone's interest that the economy grow. Local governments, however, will respond to local interests and naturally tend to favor them, even to the cost of the national interest. It is essential that the national government prevent local governments from injuring the national interest by stifling trade.

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[1] PEG is a USAID-funded Project. The views expressed in this report are those of the authors and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.

Where local governments control trade, the polity also suffers because regional and local governments engage in tariff and trade wars and discriminate against citizens from other regions. This condition encourages the development of local hostilities and animosities, prompts local governments to hoard what are in fact national resources, and interferes with cooperative activities. For these reasons, many countries explicitly note, in their constitutions, that domestic and international trade are matters of national concern. In other words, these countries realized that an internal common market, where there are no internal barriers to trade, is a matter of fundamental importance. These constitutions therefore also provide that the national government has the power both to regulate trade and to forbid and undo local actions that may injure the national economy. By eliminating or reducing damaging and divisive political and economic fights between regional and local governments, it promotes national integrity.

These matters are particularly pertinent for a geographically large and diverse archipelagic country such as Indonesia that is also undertaking a comprehensive and ambitious decentralization program.

The Indonesian Constitution has no provision that ensures free and open internal trade. As the decentralization process continues and the regions gain more authority, local governments will likely seek to impose taxes on domestic trade unilaterally. For this reason, the MPR should consider amending the Indonesian Constitution to provide for free internal trade and to secure the authority of the national government to override local action injurious to the national economy.

In addition, in Indonesia, current national policies regulating the types of tariff and non-tariff barriers that can imposed upon domestic trade activities are piecemeal, open to misinterpretation and abuse and in many instances completely ignored by local governments. All such policies, whether they be laws, regulations or government instructions should be consolidated into a single law that explicitly prohibits the imposition of a variety of tariff and non-tariff barriers.

Such a law, while easy to adopt, will in practice have little effect unless there are institutions that can enforce it and that can work to implement measures that promote free, open and competitive markets. At the national level, there is a crucial need to develop an institution that will

1) monitor, and if necessary rescind, local government legislation that generate burdensome tariff and non tariff barriers in domestic trade,
2) receive and act upon complaints of trade distorting policies and practices
3) have the necessary executive authority to punish mischievous regions (perhaps via withholding central government transfers); and
4) in general promote a coherent and consistent national competition policy framework

At the local level, given that positions and promotions of local officials are likely to be increasingly determined also at the local level, it is unlikely that these officers will promote matters of national interest, such as free internal trade, when it contradicts the interest of local parliaments (e.g. to impose duties on trade at the provincial border). It is therefore important that national competition policy has outreach to the regions, through local representation as well as advocacy and socialization programs.

### *Why is Free Internal Trade Important?*

The arguments for free internal trade within Indonesia are compelling and can be briefly summarized as the following:

1. **Economic Efficiency.** Producing for a larger market allows the producer to enjoy greater efficiencies in production through specialization and economies of scale. Free internal trade also promotes greater domestic competition that ultimately spurs innovation and other efficiency seeking activities. Consumers also benefit from access to more varied goods and services and from cheaper prices
2. **Economic Development.** Inter-regional trade barriers diminish the incentive to produce an agricultural surplus. Standard development thinking tells us that development of an agricultural surplus represents an important pre-condition for the development of manufacturing and service activities.
3. **National Integrity**. Barriers create divisions. Internal barriers to the movement of goods, services and people create regulatory walls that divide people economically and politically. This favoring of local interests over national interests threatens national harmony and integrity. At this sensitive time in Indonesia's history, the nation must not permit actions that add to the risks of national disunity.
4. **International Competitiveness.** Local government imposed tariff and non-tariff barriers raises the specter of a 'high cost economy' where increasing domestic transaction costs compromise the competitiveness of national producers in international markets.
5. **Poverty Alleviation.** Recent history has shown that tariff and non-tariff barriers in domestic trade typically result in lower rural incomes. The most burdensome distortions in domestic trade tend to be restrictive marketing arrangements and informal roadside exactions - both of which drive a wedge between wholesale market and farm gate prices[2].

### *Principles*

The Indonesian nation should comprise an internal free trade union. To insure this, Indonesia needs policies and institutions that protect and promote internal free trade and the free movement of citizens. The following are minimal requirements:

1. Domestic trade and national competition policy are matters of 'national concern' and therefore not under the control of either Provincial or District level governments, except as expressly permitted by the national government.

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[2] Examples of 'restrictive marketing arrangements' include the geographic allocation of markets (rayonisasi) and forced monopsonies that are licensed or sanctioned by local government.

2. While decentralized, Indonesia must continue to have a unified and integrated national economy (*ekonomi kesatuan*). This means only minimal, if no barriers to inter-regional trade and business.
3. Domestic producers or distributors have the right to move and/or sell legal goods and services anywhere within the Indonesian market, free of import or export tariff and other barriers to trade.

**BOX 1**
**DOMESTIC TRADE: A NATIONAL OR LOCAL CONCERN?**

Law No. 22/1999 has provisions defining what authority is to be given to regional authorities and what is to be retained by the central government. Articles 7(1) and 7(2) of the law, outlines which areas are to remain as matters of 'national concern' and therefore not to be devolved to the regions. These include international politics, defence, justice, monetary and fiscal policy, religion, national planning, national macroeconomic development, national administration, human resource development, exploitation of natural resources, strategic high technology, conservation and national standards. Unfortunately, internal trade (and even foreign trade) is not explicitly mentioned in either of these articles

This problem was remedied to a certain extent with the issuance of the supporting regulation (PP25) for Law 22. This regulation sought to delineate responsibilities between central and local government. Key stipulations regarding central government authority in domestic trade can be found in section 5 of paragraph 2 under the title of 'Field of Industry and Trade' (*Bidang Perindustrian dan Perdagangan*). Specifically, sections 5c and 5e require that regulations governing business competition (*persaingan usaha*) and the movement of goods and services domestically (*lalu lintas barang dan jasa dalam negeri*) should remain matters of national concern. The Ministry of Industry and Trade is now considering policy options to develop the necessary operational ability to implement these sections of PP25.

### *Policies to Prevent Tariff Barriers in Inter-regional Trade*

The freedom of movement of labor, capital, goods, and services from one region to another without governmental impediments or distortions is a necessary condition for the efficient function of the internal market in Indonesia. As noted by Shah (1999), "decentralized tax systems can interfere with the efficiency of the economic union [if]…the uncoordinated setting of taxes is likely to lead to distortions in markets that are mobile across states and provinces, especially capital and tradable goods."

As shown by a number of earlier studies[3], local government interference in domestic trade through the imposition of tariff and non-tariff barriers is not new. Persepsi Daerah notes that the problem became particularly serious during the second half of the New Order period

> During the 1980s and the first half of the 1990s, Indonesia's rural sector became increasingly heavily taxed and regulated. There was growing concern about a decline in incomes of the original producers

[3] See for example the various reports produced by Persepsi Daerah (1999), Tomayah (1997), Juanita (1997), Garcia (1997), Andari, Hunga and Sandee (1997), Rahma (1997), Darma (2000), Quizon, Rahma and Tomayah (1997) and the various commodity studies produced by the TIP-USAID project at the Ministry of Industry and Trade in 1996.

> of rural products (mostly agricultural goods but they included other low value, resource based commodities, usually minor mining products such as sand, gravel, clay etc). Producers received an increasingly smaller percentage of final prices for their goods. Agricultural incomes were subjected to downward pressures, which distorted prices. Incentives to increase production decreased. The desire to produce a surplus for trade fell (1999, p.1).

Indonesia has some existing policies that deal with this issue, and it is important to ask whether these policies are sufficient, under decentralization, to ensure free, open, and competitive markets. In 1997 and 1998, concerned to create a more efficient distribution system, and responding to pressures to deregulate the domestic economy, the central government initiated a number of measures to eradicate a number of tariff and non-tariff barriers in internal trade.

**Law 18/1997**

Most well known and effective of these measures was *Law 18/1997.* This law significantly reduced the number of trade distorting taxes and levies that Provincial and District authorities could impose. With the passage of this law, the wedge between farmgate and market prices was reduced, and farmers were able to command a greater share of final wholesale prices. This raised farmer incomes and stimulated regional trade and production activities (see box 1 for an explanation of Law 18/1997 and its impact upon the rural agricultural economy).

Despite the positive stimulus Law 18 provided the agricultural sector, it proved unpopular. In 1999 and 2000 pressure grew to repeal or at least to substantially modify the law[4]. The general argument was that, in the spirit of decentralization, local, rather than central, government should have the authority to regulate taxes and levies (*retribusi*) on domestic trade and business activities. Local governments criticized Law 18/1997 as not providing them enough flexibility for to raise funds from local sources.

At the local level, there was enormous hostility toward the law and the central government for imposing it. Local government officials interviewed in Central Java argued that the law had been a disaster and had ‘ruined everything’ (‘*hancurkan semuanya’*), meaning, essentially, that it had deprived them of necessary revenues. While local government officials may have this perception, it appears in fact to be a wrong conclusion about the operation of Law 18.

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[4] See for example the following newspaper articles: ‘PP Otonomi Daerah diluncurkan 7 Mei 2000’ *Bisnis Indonesia*, April 28 2000; ‘UU Pajak & Retribusi daerah perlu diubah’, *Bisnis Indonesia* April 11 2000; ‘UU Pajak perlu diubah agar Pemda leluasa’, *Bisnis Indonesia* April 18 2000; ‘Daerah tunggu PP implementasi UU Otonomi & Perimbangan Keuangan’, *Bisnis Indonesia* May 8 2000. The Indonesia Forum has also weighed into the debate by arguing that UU 18/1997 must be revised or ‘perfected’ to ensure greater flexibility in revenue raising for local governments. See Yayasan Indonesia Forum (2000) *Laporan Hasil Kajian Otonomi Daerah’* presented at the Konperensi Nasional Tentang Otonomi Daerah, President Hotel, Jakarta 9 May 2000.

**BOX 2**
**LAW 18/1997 AND THE RURAL AGRICULTURAL ECONOMY**

In 1995 the rural sector paid some of the highest tax rates in the country. This heavy tax burden was in large part caused by the frequent imposition of taxes, levies and other more informal charges upon the physical quantities of agricultural goods, often during transport. In a number of cases the market price of agricultural products were many times higher than the farm gate (producer) price. The net result of these price distortions was lower farmer incomes and higher consumer prices.

A number of factors have been put forward as contributing to the high rate of tax and other distortions on domestic agricultural trade:

- The restrictions on local authorities to tax income and assets, thus leaving trade as an obvious and natural target.
- The lack of an effective review process of relevant laws and regulations within local parliaments
- Relatively low and/or declining rural agricultural incomes providing fertile ground for the emergence of opportunistic rent seeking activities

Law 18/1997 significantly reduced the number of trade distorting taxes and levies. Most importantly, provincial and Kabupaten authorities were no longer permitted to tax agricultural products involved in inter-regional trade. To offset the loss in fiscal revenue for the regions, the central government allowed the collection of land transfer taxes, gasoline taxes, category C mining taxes and use of underground water charges.

Evidence to date suggests that Law 18/1997 was quite successful (although not in all areas) in reducing the wedge between farm gate and consumer prices. A comprehensive series of studies were carried out by a World Bank funded NGO (SMERU - *Persepsi Daerah*) over 1998/99. These studies essentially monitored the impact of Law 18/1997 upon local trade and production activities and also the impact upon local government finances. Using their primary data from 14 provinces for 23 commodities, the following summary table can be constructed

**Proportion of final wholesale price received by farmers (crude average)**

| Prior to Law 18/1997 became effective (pre May 1998) | After Law 18/1997 became effective (mid-late 1999) | Change (in percentage points) | Implied change in farmer's gross revenue (assuming constant quantity) |
|---|---|---|---|
| 74% | 83% | 9% | 12% |

Source: Persepsi Daerah (1999)

Prior to Law 18/1997 becoming effective (May 1998), farmers and small-scale producers received approximately 74 % of final wholesale price for their produce, increasing to 83%[5] after deregulation. The difference in these two figures represents the loss to local authorities from the various taxes, charges and levies that were later banned by Law 18/1997. If we assume that farmers continued to produce at constant levels, this change in the percentage of wholesale price received translates into a 12 % increase in gross revenues. The reality confronting many rural agricultural producers is that they operate on very slim margins, and often at a loss when market conditions are not favorable. Thus an increase of 9 % in the share of the final wholesale price delivered to farmers could well imply a dramatic increase in profit margins and real incomes.

[5] It should be emphasized that these figures are only averages. For some areas there were considerable variation in the pre and post deregulation figures.

Montgomery, *et.al,* (2000), drawing upon the research findings of the SMERU *Persepsi Daerah* program, concluded that the major cause in the decline in local tax proceeds was not Law 18, but the crisis driven collapse in taxes collected from new vehicle registrations and vehicle transfers.[6] At the district level the contribution of PAD to local budgets was typically so small (approximately 9% on average in 1998/99) that any decreases in locally sourced revenues were negligible in terms of the overall revenues, which are, and remain, dependant upon revenues from the central government.

Note that truck drivers, traders, farmers and others involved in the domestic movement of agricultural produce have long complained that it is not so much the formal taxes and charges that are burdensome. Rather it is the accompanying '*pungutan liar*' or illegal exactions that are much more burdensome, as they are erratic in their imposition. Through deregulation, Law 18/1997 reduced the exposure of the private sector to this form of rent seeking and as a result, the law restricted the informal incomes of local governments. Therefore a large part of the explanation for local hostility toward Law 18/1997 is its effect on the income generating routines of local officials. Law 18/1997 drastically reduced the types of taxes and retribusi permitted at the local level and consequently removed many rent-seeking opportunities that taxing and retribusi occasions provided.

## Regulations following Law 18/1997

As noted by Montgomery et.al (2000), local government officials initially ignored Law 18. They instead continued to impose burdensome taxes and charges on agriculture. Following the GOI-IMF letter of intent in January 1998, the central government issued a number of regulations and instructions to ensure local government compliance with Law 18/1997 (see box no. 3)[7].

**BOX 3**
**GOVERNMENT REGULATIONS AND INSTRUCTIONS FOLLOWING THE JANUARY 21 1998 LETTER OF INTENT DESIGNED TO DEREGULATE DOMESTIC TRADE.**

- *Instruksi Presiden (Inpres)* No. 1, 1998 that prohibited or removed all taxes, fees and levies on export products at all levels.
- *Inpres* No. 2, 1998 instructed all relevant government officials down to kabupaten level that they may not prohibit trade, must remove any trade prohibitions, may not restrict trade within or between provinces, and must remove any trade restrictions.
- *Inpres* No. 5, 1998 immediately instructed he Ministers of Agriculture, Home Affairs, Cooperatives, Finance, Industry and Trade, Public Works, the Governor of Bank Indonesia, the Head of Bulog, all Governors and Bupatis to cease implementation of previous *Inpres* related to sugar planting. This *Inpres* thus released farmers from all formal and informal requirements to plant sugar cane.

[6] Local revenues, or Pendapatan Asli Daerah (PAD) consist of five categories: taxes, levies, user-charges for facilities and services, profits form local government enterprises and others sources.
[7] According to Point 42 of the January 1998 Letter of Intent ' The government is now enforcing the prohibition of retribusi (local taxes) at all levels on export goods. To strengthen the competition and market integration the government will develop and implement a one-year program for abolishing taxes on inter-provincial and inter-district trade. Any loss of local government revenue will be addressed through a combination of local fuel taxes and transfers from the central government'

• *Keputusan Presiden (Keppres)* No. 21, 1998 which decontrolled trade in cloves.
• A letter from the Minister of Industry and Trade *(Surat No. 44/MPP/I/1998)* to the Minister of Agriculture, dated January 21, 1998. This letter notified the Minister of Agriculture that restrictions in trade of livestock between provinces must be eliminated by February 1, 1998.

In addition to these measures, and based on Law No. 18, 1998 (and pushed by the LOI) on 23 March 1998 the Government issued:
• *Instruksi Menteri Dalam Negeri (Mendagri)* No. 9, 1998 which gave details on the prohibition of imposing any kinds of tax or levy on export goods and the removal of all restrictions on trade between provinces, *kabupatens* and islands.
• *Instruksi Menteri* No. 10, 1998 which required the replacement of all local regulations (Peraturan Daerah or Perda) at the province and *kabupaten* levels (Tingkat I, Tingkat II) related to taxes and *retribusi* within a certain time period.

Source: Persepsi Daerah (1999)

**Law 34/2000**

In response to local government pressures, the DPR substantially modified Law 18/1997 in the later months of 2000 by adopting Law 34/2000. If Law 18/1997 was written in the spirit of eradicating the 'high cost economy', then the new Law (34/2000) was written to authorize regency (Kabupaten) level governments to create new taxes and charges. This is clearly reflected in the addition of articles that authorize regency level governments to stipulate new taxes in regional regulations, beyond those Law 18 allows, if they fulfill the following criteria:

*a) having the characteristics of a tax and not retribution*
*b) the tax object is located or situated in the relevant Regency/Municipality and has relatively low mobility and only serves the people in the relevant Regency/Municipality*
*c) the object and basis of tax assessment are not in contradiction with public interests*
*d) the tax object does not constitute a tax object of the Province and or a tax object of the Central government*
*e) having sufficient potencies*
*f) do not cause negative economic impacts*
*g) taking the aspects of justice and public welfare into account*
*h) conserving the environment*

Law 34 also expands on the criteria determining the legality of retribution levies, as stipulated in local government regulations. Article 18 provides a long list of criteria falling into three broad categories: Public Service Retribution, Business Service retribution and Specific Licensing retributions. The criteria for each of these categories can be summarized as follows:

***Public Services Retribution:***
- The retribution fee is in return for specific services or benefits

- The retribution constitutes the authority of the regions and is not in contradiction with central government authority
- The retribution shall be collected in an effective and efficient manner
- The collection of retribution fees allows better delivery of services

***Business Services Retribution***

- Services concerned can be commercial services not adequately provided by the market, or services that can be provided through the use of under-utilized assets owned or controlled by the local government

**Specific Licensing Retribution**

- Licensing required to 'protect the public interest'
- Licensing fees required to cover, at least in part, the high costs of specific local government licensing activities

Other types of retribution fees can also be stipulated by regional regulation insofar as they satisfy the criteria summarized above.

In terms of monitoring the issuance of new local regulations stipulating new taxes and retribution fees, Law 34/2001 (sections 5a and 25a) requires the following

- The regulation must be submitted for central government review with 15 days of issuance
- If the regulation is found to be contradictory to the public interest and/or laws or regulations at a higher level, then the central government may rescind the regulation
- However this rescission by the central government must be conducted no later than one month upon the receipt of the regulation

In term of protecting flows of internal trade there are three important points that can be distilled from the amended law:

1) Article 2(4b) requires that tax objects have relatively low mobility – this may help to prevent multiple taxes being imposed by regency level governments on the same object, such as truck carrying agricultural produce from one regency to another.
2) Article 18(3a) requires that retribution fee can only be charged is in return for specific service or benefit. This is an important stipulation as local governments have recently increasingly distorted the notion of user-benefit fees. For example, as explained in attachment A the Provincial Government in Lampung has issued a number of local regulations stipulating new retributions fees whereby the only benefit provided to the payer of the retribution fee is the issuance of a license (i.e. a license to export agricultural commodities out of the province)
3) Articles 5a and 25a suggest some degree of supervision by the central government.

While these provisions are theoretically useful to protect trade, it remains to be seen whether these and similar provisions are sufficient to protect the internal common market. Key questions remain:

a) Is law 34/2000 sufficient to prevent growth in commodity taxes. Article 2(4b) described above, may prevent multiple taxes on the cross-regency movement of agricultural produce, but will it prevent the imposition of taxes at the farm-gate?
b) Many of the criteria determining the legality of new taxes and retribution are worded in a vague and overly general manner. Vagueness invites misinterpretation, even abuse, by governments seeking to raise revenues in any way possible. As trade is a natural target of taxes, we can expect to hear many local governments proclaim that "public welfare" requires such and such a new tax, along with solemn findings that the new tax does not contradict the "public interest".
c) It is not clear how effective central government supervision of new local regulations will be. Given the existence of over 360 local governments, the task of reviewing all local regulations, within fifteen days of issuance, for conformity with national policy is a monumental one. As far as we can determine at the present time, there is no institution of central government charged with the responsibility for reviewing local regulations, and no central government institution has the staff or resources with which to do so. The really important questions remain unanswered. Which agency will fulfill this role and will it have the adequate capability and resources to review all incoming legislation? What happens if the legislation is not reviewed within the 30-day time limit? Do they immediately become effective? What is there to stop local governments from opportunistically flooding the central government agency as a means to introduce illegal revenue raising measures, at least in the short term?[8]

At present, the central government has apparently authorized local governments to impose new taxes on economic activities (including trade depending upon local government interpretation of Law 34/2000), but hopes, in vague and unenforceable ways, that such taxes will not harm the national economy. Given local self-interest and the pressure to raise revenues, it is much more likely that local governments will create many trade hindering and burdening taxes. Given legitimate doubts about the central government's ability to protect domestic free trade from local government predation, it would appear better to restrain local governments from taxing trade. This warrants both a law forbidding such taxes as well as a law that, in order to relieve the pressure to tax trade to raise revenues, provides alternative ways to raise them.

## Does Indonesia Need a New Law?

How effective would another law (Undang-undang) be in preventing local governments from imposing tax type distortions on domestic trade? This is an important question to

[8] In some ways the question of whether the transformation of Law 18/1997 to Law 34/2000 represents an improvement, or a regression, in terms of ensuring free internal trade is academic. With the passing and then operation of Law 22 on decentralization, many local governments have simply chosen to ignore Law 18/1997. A well-known example of this is in Lampung where a number of local regulations were produced last year in an effort to raise PAD through various taxes and charges on trade. These preamble for these regulations acknowledge a long list of central government laws and regulations, but noticeably ignore Law 18/1997 and its supporting regulations, as well as a number of other central government instructions and regulations produced in 1998 to support the implementation of the IMF's letter of intent.

address if the Ministry of Industry and Trade wishes to produce a new law to provide the operational authority to implement the particular stipulation within PP25 (mentioned above – see box no. 1) that the regulations governing the domestic flows of goods and services will remain as a matter of national concern

If there is to be a domestic trade law, then it is important that it focus on ending local government imposed or inspired distortions in domestic trade. This would include prohibition of

1. All forms of taxes on the movement of goods and services within the Indonesian economy
2. All forms of non-tariff barriers on movement of goods and services such as restrictive marketing practices, quotas, export restrictions, forced partnerships and licensed monopsonies (see next section)

Any such law should also prevent:
1. the misuse of *retribusi* or user benefit fees, where the government provides no genuine facilities or real service;
2. misuse of the Third Party Contributions facility (*sumbangan pihak ketiga* - SPK) to impose tax type barriers on domestic trade (see box 3 below)
3. local governments from maintaining local tax authority by setting banned taxes or charges at zero instead of abolishing them. As noted by Bennett (2000), this makes reinstatement easy, as it requires a Bupati's signature rather than local parliament approval for new taxes

The law should also prohibit the practice of providing commissions or 'incentives' to government officials or third parties who collect local taxation and retribution fees. This tends to promote opportunistic rent seeking and also the involvement of local 'preman' (hoodlums)

A comprehensive national trade law might cover many things. The problem of local government creation of trade inhibiting taxes or non-tariff barriers to trade, however, is an urgent problem that, in the interests of national economic recovery, needs immediate attention and solution. What this suggests is that the central government not delay solving this problem while awaiting the perfection of a comprehensive trade law, which might cover secondary objectives such as the maintenance of product standards and the prohibition of 'hoarding' activities. The issue of free internal trade is simply too important and urgent to admit of any delay in solution.

**BOX 4**
**THIRD PARTY CONTRIBUTIONS – 'SUMBANGAN PIHAK KETIGA'**
**A NEW *DE FACTO* TAX ON TRADE**

Local governments are becoming increasingly inventive in finding ways to tax trade. The 'third party contributions' facility (or SPK), for example, is rapidly becoming a *de facto* tax on trade in a number of outer provinces. This facility requires local business to provide 'voluntary' payments to local government. The SPK operates as a tax, but it is not recorded as such within government accounts. This is because it is meant to be a 'contribution' or 'gift' from the community to local authorities. Third party contributions are classed as 'other sources of income', and are therefore not affected by the reform measures contained in Law no. 18 /1997.

Since the implementation of Law no. 18/1997, provincial and kabupaten governments have used third party contributions to increase revenues, or at least to offset the expected fiscal losses associated with the removal of the various kinds of trade taxes and levies. Examples of the misuse of SPK facility can be found, amongst other places, in the province of Nusa Tenggara Barat, where tobacco producers are obliged to 'volunteer' Rp. 80 to local coffers for every kilogram produced. Similarly, in the cattle market in Mataram, Lombok, traders must pay SPK Rp 2000 for each head of cattle traded.

Devices ranging from subtle pressure to explicit threats of punitive action serve to collect this levy. Forced "voluntary contributions' are neither voluntary nor contributions. They are taxes, plain and simple, and should be acknowledged as such. As taxes, they must be examined for their trade distorting and inhibiting effects. Where permitted, as taxes on trade, they should be subjected to tests of transparency and evenhandedness.
Source: Goodpaster and Ray (2000)

Local governments have legitimate demands for authority to impose local taxes. All governments need revenues to operate, and the more services local governments wish to provide, the more revenue they will need to raise. Local governments should not tax trade because doing so injures the economy, local as well as national. On the other hand, if deprived of trade taxes as a source of revenue, what are local governments to do?

Indonesian local governments are prone to tax trade because the present taxation system doesn't give them many alternatives. Local governments are mostly unable to draw local revenues from taxes on assets, incomes and value added, leaving trade as a residual and obvious target. Another reason is that it is very simple to tax trade. This is done by positioning officials at key strategic locations, such as at city and district boundaries, weigh stations, ports, bridges and crossroads. As noted earlier that the more contact local officials have with businesses, traders and farmers the more opportunity there is to extract informal or illegal charges (*pungli*). For these reasons it may be appropriate to consider devolving other taxation powers (such as property or value added tax) from the center to the regions.

### *Non-Tariff Barriers*

While equally, and in some cases, more injurious to trade, compared with taxes, non-tariff barriers (or NTBs) in domestic trade are less immediately obvious and possibly somewhat harder to address than a simple law outlawing taxes. Common NTBs within

Indonesia are essentially anticompetitive practices, and include restrictive marketing practices, quotas, embargos and export restrictions, local processing requirements, forced partnerships and licensed monopolies and monopsonies.

Local governments impose NTBs for a variety of reasons. In some cases it is to give market advantages to certain persons, to discriminate in favor of local business, or particular elements of the local business community. In other cases, it is a misguided effort to attempt to improve the local economy through market defeating regulation.
For example, a local government might impose a local processing requirement on a locally produced product in the hopes that this will create more employment. Unfortunately, the market may demand unprocessed product. This means that the local rule is self-defeating because there will be fewer sales of the product.

Regardless of the reasons, NTBs on agricultural trade at the local level typically result in distorted agricultural prices, leading to lower farmer and small producer incomes and higher consumer prices. What is true of agricultural trade is true of other trade as well. If a local government, for example, allocates to a few local buyers the right to buy fish sold in the jurisdiction, it thereby limits the fish buyers' market. Local fishermen are injured because there is less competition for their product, and they will receive less income. Consumers will be injured because few wholesale fish buyers mean few wholesale fish sellers, likely the same parties. If a few parties control the supplies of fish to the retail or consumer markets, they can charge higher prices. Even if the local government intention is to insure enough fish for local demand, what they have in fact done is to injure fishermen and consumers while providing the wholesale buyers excess profits.

Internal export quotas are another commonly used scheme. If there is an inadequate supply of a good that must be distributed fairly, then a distribution quota might make some sense. But quotas in Indonesia often operate to restrict the distribution of what is plentiful. This kind of quota has adverse economic effects because producers, faced with a limit on what they can sell, will reduce their production. If the demand is there, the artificial restriction of a quota injures consumers. Such product as they can get will be more expensive because of limited supplies. Even worse, as appears to have happened with some tree crops in Indonesia, producers stop producing at all.

We could multiply examples, but the point would be the same. Because they interfere with the free flow of domestic trade, the national government should enact legislation preventing local governments from authorizing any of the following non-tariff barriers

1. **Price Controls,** i.e. imposing maximum or minimum price controls on goods sold or produced within the same region. One of the principles of a free market economy is that the market determines prices. Price controls prevent markets from giving appropriate price signals and therefore distort production. When price controls are in effect, producers attempt to evade them. If the control calls for a maximum price within the jurisdiction, the producer will attempt to sell the product outside the jurisdiction. (Although it is a case of subsidy rather than price control, consider the smuggling of Indonesian kerosene to Singapore as an example of what is likely to

happen.) If the price control establishes a minimum price, purchasers will seek to buy outside the jurisdiction, thus reducing local demand. (Note also that, for these reasons, price controls usually require a whole host of ancillary actions and regulations to make them effective.)

2. **Quantitative restrictions on inter-regional trade,** i.e. imposing quotas on goods and commodities involved in inter- and intra-regional trade (e.g., as commonly the case for the movement of cattle out of South Sulawesi and Nusa Tenggara Barat). There is simply no economic justification for imposing quantitative restrictions on trade between areas. As noted above, such restrictions reduce production and raise costs.
3. **Required in-region processing of local raw produce,** i.e. forcing local farmers and producers to sell their produce to in-region downstream processors by banning or inhibiting sales to out-of-region processors. In a free market economy, local processing of raw produce will occur if it is profitable. A local government might have a reason to assist local processing to develop, say if there is insufficient capital or a lack of local knowledge – as long as there is a genuine market for the locally processed goods. But here the government should act as a facilitator rather than as a regulator, for the government generally does not know what the market wants or needs. Furthermore, in Indonesia in the past, local officials have imposed local processing requirements simply to benefit the local processor, usually to the serious disadvantage of the local producer who found their market for sales substantially reduced.
4. **Forced sales to local monopsonists**, i.e. forcing local producers to sell their produce to particular buyers, including those which are local government-owned cooperatives (KUD). As noted above, such forced sales harm producers and consumers.
5. **Regional allocation of markets *(rayonisasi)***, i.e., licensing the division of marketing/production territories and/or the allocation of markets for buyers or producers. Rayonisasi is anticompetitive. The practice secures certain markets for certain parties. Without competition in their market, the holders of these rights can, depending on the circumstances, pay reduced prices for the goods they need for their own production; charge higher prices for their products; and produce inferior products. Suppliers and consumers are therefore injured.
6. **Forced partnership programs *(kemitraan),*** i.e. forcing or coercing small-scale producers such as farmers into partnership programs. While sometimes the intention may be good, e.g., an effort to transfer skills, tying small producers to a larger partner makes them captive of the latter. In a competitive economy, producers will gravitate toward whatever opportunity serves them best. If such partnerships are valuable, they will occur naturally, and involvement in such programs must be purely voluntary.

In addition to specifically outlawing these practices, the government must also realize that people are endlessly inventive. There is a host of ways that local governments can devise to burden internal trade, favor locals over outsiders, and to discriminate against out of region business. For example, without directly targeting trade, a local government could impose so-called health, safely and transport regulations whose real aim was not to protect against some harm, but to target free trade. Suppose a local government bans the importation of goats from an adjoining region. This might be done to protect the local goat population from some communicable disease carried by such out-of-locale goats; or it might be done in order to protect local goat farmers from competition. Someone, or institution must determine whether such regulations are actually necessary and that they do not interfere with trade any more than necessary. In other words, in addition to outright banning certain NTB practices, the government needs to create some mechanism for review other trade harming practices that local governments might invent.

The experience of other countries, or groups of countries, that have dealt with the problem of internal free trade – such as the Canada, the United States, Australia, and the European Union – reveals that the problem of locally imposed trade barriers is persistent and ongoing. These countries have all decided that they need some institution responsible for enforcing internal free trade policy, an institution capable of receiving and acting on complaints from injured parties, and capable of rescinding local enactments and actions that interfere with free trade.

### *Institutional Development*

It is essential for the national government to insure that all of Indonesia remains a free trade area. In order to do this, in addition to outlawing certain taxes and practices, the government needs to create or designate some institution that can review trade distorting local legislation and actions and that can receive and act on complaints.

There are a number of options, and combination of options, that the government should consider. It could:

- Form a new inter-ministerial committee or body (with a functioning secretariat), as currently being planned by the Ministry of Home Affairs
- Empower an existing section of central government to undertake the necessary activities
- Modify function of KPPU so that it could adjudicate trade restrictive practices of local governments
- Consider an number of overseas models –
    - Charge an agency with the responsibility of reviewing any legislation that restricts competition, such as Australia has done with the National Competition Council
    - Under clear guidelines and standards for review and adjudication, assign the responsibility for adjudicating complaints regarding trade restrictive practices to the courts.
- Empower the executive to discipline local governments that introduce restrictive trade practices by
    - financially rewarding those governments that do not do so
    - financially punishing those governments that do, e.g., by withholding government grants.

There are, of course, pros and cons to all of these options, and they should be debated at length. Assuming that the government wishes to enhance, rather than hinder, domestic trade, the government must decide how it shall do so. At the same time, the government needs to take into account the legitimate revenue needs of local governments. Removing the perceived need of local governments to tax trade by authorizing them to access other sources of revenue would solve much of the taxation problem. Requiring local governments to abide by competition rules and give up anticompetitive practices would solve much of the NTB problem. Whatever solutions the national government devises to the economically injurious problems presented here, they should be genuinely effective and also able to respond to new threats as they arise.

## *Attachment A: A Case Study of Inter-regional Trade Barriers in Lampung*

As is the case with most non-oil producing provinces, there is an increasing sense of urgency to find and exploit new forms of locally sourced taxation revenues (PAD) in Lampung. To this end, the Lampung provincial government last year passed a number of local regulations (or P*eraturan Daerah* – i.e. *Perda*). Unfortunately, many of these regulations generate serious distortions to the trading environment and, in addition, violate key stipulations of Law 18/1997[9]. The table below provides a brief description of these regulations.

| No | Title | Description | 5 percent collectors' incentive |
|---|---|---|---|
| 1 | Retribusi Pengujian Kendaraan Bermotor | Mandates 6 monthly roadworthiness tests for all vehicles (including cars, buses and trucks) using Lampung roads. Requires multiple tests, payments, documents and visitations to local government offices and local government owned vehicle inspection centres. In the regulation there is no apparent exemption for non-Lampung registered vehicles, suggesting that this might be used as an excuse to intercept through-trade. | Yes |
| 2 | Retribusi Pengujian Kapal Perikanan | Similar to regulation no 1, except for fishing ships and boats using Lampung ports and waters. The inspection permit is valid for 12 months | Yes |
| 3 | Retribusi Tempat Pendaratan Kapal Perikanan | Landing fee for fishing ships and boats using Lampung ports provided by local government | No |
| 6 | Retribusi Izin Komoditi Keluar Propinsi Lampung | Imposes a tax or 'license fee', of between Rp. 2/kg. and Rp. 150,000 /kg. on 180 commodities exported from the province. The regulation also requires that products of non-Lampung origin to be taxed if there is no proof of origin. The proof of origin requirement mandates traders to apply for a '*surat jalan*' (transportation permit) from the Kabupaten of origin. This adds considerable time and expense to the simple task of transporting agricultural produce across provincial boundaries. | Yes |
| 7 | Retribusi Izin Pemungutan Terhadap Pengambilan Hasil Hutan Bukan Kayu di Kawasan Hutan | Those producing non-wood products (such as vegetable and fruit crops, bamboo, cengkeh etc) in protected forest areas must pay to the provincial government a 10 yearly licensing fee and a set rupiah amount per kilo produced. This regulation sends a dangerous message to farmers that it is OK to destroy native protected forests as long as local government levies are paid | Yes |
| 8 | Retribusi Pengangkutan Bahan Galian Batubara Bahan Baku Semen dan Barang Barang Potensial Lainnya | This regulation is designed to compensate the community from the negative effects of the transportation of cement, coal and other 'potential materials'. It is only collected at the railroad and is therefore intended to intercept through trade. The fee is Rp 3000 per ton of coal, Rp 1000 for cement and an amount determined by the DPRD for other materials. | Yes |

[9] Law 18/1997 banned all forms of taxes and charges on inter-regional trade, but was recently amended to become Law 34/2000 to allow for greater flexibility in revenue raising for local government.

| | | | |
|---|---|---|---|
| 9 | Retribusi Izin Penyimpanan / Penimbunan Semen dan Batubara Serta Mineral Lainnya | This fee is for the service of issuing a license to store coal, cement and other minerals before loading on to ships. It is not a storage service fee but simply a fee to get local government permission to store/stockpile. The government does not provide storage facilities, but taxes those that use the facilities provided by the private sector. A 5 yearly license is required and a fee must be paid (Rp 2500 per ton of cement, Rp 10000 for coal and an amount determined by the DPRD for other minerals) for each storage. | Yes |
| 10 | Retribusi Pelayanan Karantina Hewan, Ikan dan Tumbuhan Antar Area. | All livestock, fish and plant matter (dead or alive, processed or unprocessed including fruits and vegetables) entering and leaving Lampung must be inspected for quarantine purposes and the various fees and levies paid. All quarantine inspections are carried out by the local government (or parties sanctioned by the government). A detailed 11 page schedule attached to the regulation outlines the many and varied quarantine charges. | Yes |
| 11 | Retribusi Izin Dispensasi Jalan dan Retribusi Kompensasi atas Muatan lebih Angkutan Barang yang Memanfaatkan Ruas Jalan dan Jembatan pada Jalan Nasional dan Jalan Propinsi dalam Wilayah Propinsi Lampung | This regulation requires those with heavy or dangerous loads to apply for a permit to travel on Lampung roads, before travel. Pre-travel it involves payment of substantial fees, much paperwork, reporting and visits to government offices. This regulation does not stop seriously over-weight trucks from using Lampung roads, but simply extracts a fee from those that do. It will be interesting to see whether the funds collected through this facility are channeled into road/bridge maintenance and development | No |

The regulations described above increase the costs of transporting produce, both within and through Lampung boundaries. Traders and truck drivers are to be taxed not only at provincial boundaries (or designated posts acting for the provincial authorities) but also at Kabupaten (sub-district) boundaries[10]. These extra costs depress farmgate prices, and also undermine the competitiveness of local producers in national and international markets.

The regulations are significant not only in terms of the Rupiah value of the expected (formal) exactions but also due to the fact that their imposition implies greater contact between local government officials on the one side and farmers, traders and truck drivers on the other. Increased contact of this type typically results in more opportunities for the extraction of illegal fees and levies.

All regulations call for the collection of *retribusi* fees. Retribusi (or user pay fees) should only represent a chargeable fee for a service which provides some value to businesses. For many of the regulations there is no real service provided. For example in local regulations 6, 7, 8, 9 and 11 the service provided is merely the issuance of a license. In

[10] Regulations have also been issued at the Kabupaten level that are designed to raise funds by taxing trade. In Kabupaten Tulang Bawang a regulation was issued in July 2000 which seeks to tax sales of seeds (and other inputs) as well as the final output from plantation crops. In another Kabupaten, Tanggumus, a regulation has been issued to collect a marketing fee from food crop commodity traders, via their trade association. The fee is determined by the volume of commodities traded.

other cases the Lampung government creates new and unnecessary services for which fees can be charged. For example, *Perda No. 1 Tahun 2000* stipulates that all road vehicles, including trucks, buses and cars, must pass 6 monthly inspections to ensure road worthiness. All vehicles using Lampung roads are subject to this regulation. It is not stated within the regulation that vehicles from outside of Lampung are exempt, meaning that the regulation might be used as an excuse to intercept through-trade.

Questions must also be asked about the quarantine regulations (*Perda No. 10 2000*). In particular, is it really necessary for a province to have such detailed and complex testing and quarantine requirements for virtually all animal and vegetable products passing through provincial boundaries? If all provinces issued similar quarantine requirements flows of internal trade would be seriously obstructed. However in Lampung it seems that little quarantine inspections are actually carried out, but the inspection and quarantine fees are nevertheless collected.

For most of the regulations there is a 5% incentive for the collecting agency or individual. It is not clear who the collecting agency will be, but some government officials suggest that it might be contracted to the private sector. The reward of 5% of all monies collected will provide a substantial incentive to the collecting agency to maximize the number and amount of exactions.

It is also interesting to note that each regulation acknowledges a variety of laws and regulations dating back to the 1960s on the status of local government(s) and its (their) ability to raise taxes. The regulations also acknowledge the new laws on decentralization. There is however, no acknowledgement of Law 18/1997 and a variety of central government instructions in 1998 which banned all taxes and most retribusi imposed on domestic trade.

Another common feature of the regulations is that the governor has complete discretion to reduce the various fees imposed by these regulations, and even to exempt businesses, or sectors as he sees fit. One common complaint from businesses interviewed is that the Governor appears to respond to objections from one group, but ignores similar objections from others. For example, the export-licensing fee for pigs was reduced from Rp 30,000 to Rp 2000, but similar complaints from cattle traders and producers were ignored and the export fee of Rp 20,000 remains (which most producers and traders complain is quite burdensome).

Another common complaint relates to the sometimes-curious logic used to determine export fees for particular products. One glaring example is *Ampas*, the by-product or waste from the processing of sugar cane. Although it is a waste product, it does have some economic value and is therefore traded. Its current price is around Rp 5 per kilo. However the export fee imposed upon this product was Rp 8, resulting in the waste product being discarded.

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